

The Newest Player in the Climate Change/Renewable Energy Game: EPA's \$100+ Billion Clean Water State Revolving Fund

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On August 13, 2013, the state of New York set an important legal precedent that could help to retard climate change and reduce greenhouse gas (GHG) emissions in the United States.

On that day, the New York State Energy Research and Development Authority (the Authority) issued \$23.4 million in bonds to fund residential energy-efficiency projects. The bonds were rated AAA/Aaa, thanks to a financial guaranty from the New York State Environmental Facilities Corporation (EFC). What was astonishing was that the EFC, which manages the Clean Water State Revolving Fund (CWSRF) in New York, used legal authority under the *Clean Water Act* (CWA)¹—not the *Clean Air Act*²—to effectuate the guaranty. In effect, the EFC used the net assets of its CWSRF program to credit-enhance the bonds of its sister agency that does energy projects. This is the first-ever transaction to provide linkage between clean energy and clean water programs. It is also the first stand-alone use of an SRF guaranty in the capital markets—but more about that later.

The transaction was so significant that it won a National Deal of the Year Award from the *Bond Buyer*, the authoritative publication in the public finance industry. The award is an annual contest that recognizes innovation and prestige in municipal infrastructure finance. The transaction was recognized for its significant reduction of the bond debt service and establishment of a nationally replicable model.

In July 2013, both Moody's and Standard & Poor's rating services assigned their highest ratings to the Authority's residential energy-efficiency financing revenue bonds Series 2013A, which were issued three weeks later. The ratings are based on the EFC's commitment and ability to make full and timely payments of principal and interest should the Authority become unable to do so. This use of a guaranty by the EFC will significantly expand New York

State's—and, hopefully, many other states'—toolbox to fund residential and commercial energy-efficiency projects.

This is an entirely new territory for the U.S. Environmental Protection Act's (EPA's) CWSRF, which is celebrating its 25th anniversary and the fact that it has provided over \$100 billion of financial assistance. Of this \$100 billion, over 96% has gone to sewage treatment plants and the other 4% has gone almost exclusively for agricultural nonpoint source water pollution reduction projects.

The authority for the CWSRF is contained in Title VI of the CWA, which was added, *inter alia*, by the 1987 Amendments.³ Section 601(a)(2) provides that the EPA Administrator shall make grants to the states "for implementing a management program under Section 319."

Section 319 is entitled "Nonpoint Source Management Programs." Although pollutants such as nitrous oxides may emanate from a smoke stack, exhaust pipe, or some other "point source" of air pollution, once they are airborne and destined for some receiving water body, they become a "nonpoint source" of water pollution as far as that receiving water body is concerned. As such, the atmospheric deposition of air pollutants into a state's water bodies may or may not be included in any given state's Nonpoint Source Management Program (319 Program). In the case of New York, "atmospheric deposition" is listed prominently on page one of its 319 Program.

The purpose of the EFC is to provide low-cost capital and technical advice and assistance for environmental projects in New York State. Specifically, the EFC administers and finances the state's SRF, which is the largest such program in the United States. In addition, it is responsible for the Drinking Water State Revolving Fund (DWSRF), as well as other specific environmental infrastructure projects.

Since 1990, the EFC has provided approximately \$15.5 billion in low-cost financing and grants for over 2,000

1. 33 U.S.C. §§1251-1387, ELR STAT. FWPCA §§101-607.
2. 42 U.S.C. §§7401-7671q, ELR STAT. CAA §§101-618.

3. Pub. L. No. 100-4, 101 Stat. 7, Feb. 4, 1987; *see also* 40 C.F.R. §§35.3100 et seq.

water and sewage projects across New York State. Approximately \$6.1 billion is currently outstanding.

In its 2012 Annual Report, the EFC reported net assets totaling \$5.2 billion. Strong loss coverage ability, sound financial policies and practices, very low levels of delinquencies, and favorable market position all contribute to the EFC's high credit rating. The EFC's guaranty was critically important for the Authority, which has net assets of zero and therefore no ability to back its own transactions.

The New York State Legislature created the Authority in 1975 as a public benefit corporation, with the goal of reducing New York State's petroleum consumption. Today, the Authority is funded primarily through state utility ratepayer programs. The Authority allocates its resources to energy-efficiency programs, research and development initiatives, and low-income energy programs. The primary mission of the Authority is to provide resources and initiatives for the people of New York State to reduce their energy footprint in order to improve the state's economy and environment.

How exactly did New York set this groundbreaking and important precedent? They did it through an excellent marshaling of the facts and by a close dialog with the SRF program management at EPA.

According to a March 4, 2013, letter from EFC Senior Vice President & General Counsel, James Levine, to George F. Ames, Chief, Clean Water State Revolving Fund Branch at EPA:

Burning fossil fuel to generate heat and electricity in NYS contributes to atmospheric deposition of air pollutants into NYS water bodies. NY's Nonpoint Source Management Program (NY NPS Program) identifies atmospheric deposition from fossil fuel combustion as a significant source of water quality impairment and calls for additional controls over, and reductions in atmospheric deposition of such air pollutants into NY's waters. We believe an adequate relationship exists between the environmental benefits of NYSERDA's Residential Energy Conservation Projects and the remedial action called for in NY's NPS Program regarding atmospheric deposition such that EFC's provision of CWSRF financial assistance can be characterized fairly as assisting in the implementation of NY's NPS Program. We believe this relationship, when coupled with the SRF operating flexibility intended to be afforded to the States, the increasing emphasis on creative use of the CWSRF and the increasing concern about the water quality impacts of atmospheric deposition justifies qualifying such a project under the CWSRF.

We propose to qualify NYSERDA's portfolio of Residential Energy Conservation Projects as an eligible Section 319 project qualified for financial assistance by the CWSRF under Section 603(c)(2) of the Clean Water Act and the implementing federal guidelines governing the Clean Water State Revolving Fund (CWSRF).

On March 22, 2013, Ames officially responded to Levine's request. The relevant sections of Ames' letter are as follows:

From your letter, we understand that the assistance to be provided would either be in the form of Clean Water State Revolving Fund (CWSRF) bond proceeds used to purchase NYSERDA bonds or by NYSERDA issuing its own bonds supported by a CWSRF guaranty. NYSERDA would use these funds to provide low interest loans to a wide range of recipients such as residences, small businesses and non-profits. The loans would finance "Residential Energy Conservation Projects," including high efficiency heating and cooling measures and energy star appliances.

The NYEFC proposal notes that: "NY's Nonpoint Source Management Program identifies atmospheric deposition from fossil fuel combustion as a significant source of water quality impairment and calls for additional controls over, and reductions in atmospheric deposition of such pollutants in NY's waters." The proposal goes on to state that the environmental benefits of NYSERDA's RECPs assist in the implementation of the State's Nonpoint Source Program.

You asked us to consider the proposal essentially in terms of the eligibility of the RECPs as CWSRF projects. We agree that the projects as described would be eligible.

So, what does this all mean?

It means that New York has used a clean water finance program to facilitate the funding of clean energy projects. More importantly, it means that other states can do the same.

Before we discuss how other states might take advantage of this opportunity, we need to analyze the New York transaction.

Under Title VI of the Act, states are given several options to finance clean water projects. For example, §603(d)(1) provides that they can make direct loans for terms of up to 20 years. Paragraph (2) authorizes SRFs "to buy or refinance the debt obligation of municipalities and intermunicipal and interstate agencies within the State." And, Paragraph (3), which is the most important provision, authorizes SRFs "to guarantee, or purchase insurance for, local obligations where such action would improve credit market access or reduce interest rates." This is the provision under which the EFC guaranteed the Authority's bond issue.

As noted above, since 1987, the SRFs have provided on a national basis over \$100 billion of financial assistance for clean water projects. This has involved over 33,000 transactions. That said, only one—1 out of 33,000—has involved the use of the guaranty authority in the capital markets.⁴ So, New York's amazing precedent was actually two equally amazing precedents: first the use of a clean

4. The capital markets are where financial guaranties have their most powerful effects. There have been a few other incidental uses of the guaranty authori-

water program to finance an energy-efficiency program, and second, the first-time use of the guaranty authority in the capital markets.

The New York precedent means that, in states where air deposition is a significant contributor to water pollution, that state's SRF can provide financial assistance to residential, nongovernmental organizations (NGOs) and small business energy-efficiency projects. Theoretically, such authority could also be used to guaranty bonds issued to finance pollution reduction systems at major power plants; but individual state policies may prohibit such action. But in any case, the CWA can be used to reduce air pollution and energy consumption.

Will these new precedent-setting uses of SRF funding capacity result in fewer dollars for traditional sewage and other clean water projects? The answer is a resounding "no." By conservative standards, the combined 51 SRFs have over \$1 trillion of financial guaranty capacity. So, venturing into new ground such as this will not even dent their fender.

So, how can other states avail themselves of this same opportunity?

There appear to be four steps. But since the end-goal is to get a guaranty from the state's SRF, we must spend a moment discussing just how the SRF program works.

Section 606(c) of the Act requires each state to prepare an Intended Use Plan (IUP) to let the public know how it intends to spend its funds. The draft IUP is a public document open for review and comment by all the people in the state. At the end of the review and comment period, a public hearing is usually held, after which the final IUP is published. This serves as notice to potential applicants of what types of projects the SRF will fund in the coming year.

After the IUP is published, applications are solicited. After the application-filing deadline passes, the SRF reviews all of its applications, ranks them, and publishes these rankings on a Project Priority List (PPL). Section 606(c)(1) provides that the IUP shall include "a list of those projects for construction of publicly owned treatment works on the State's priority list developed pursuant to section 216 of this Act and a list of activities eligible for assistance under sections 319 and 320 of this Act."⁵

At this time, the SRF usually announces the amount of money it has to spend on direct loans in the coming year and, therefore, how many projects, in descending order, it can fund on the PPL. This, of course, all has to do with direct loans. It does not concern guaranties, because guaranties do not involve an outlay of cash.⁶

Bearing the above SRF operating procedure in mind, let us return to the notion of how another state could follow

ties under the Act, but, over 25 years, they have totaled less than \$23 million combined.

5. Note that §606(c)(1) requires a list of the actual projects at publicly owned treatment works (pursuant to §216) but only a "list of activities" that are eligible under §§319 and 320.
6. And this, of course, means that the SRF can do many more projects than it has loan funds for.

New York's precedent and use its CWSRF's guaranty to finance energy-efficiency projects.

The four steps for accomplishing this are the following:

1. Identify whether atmospheric deposition is a source of water pollution in the state.
2. If so, include it in the state's 319 Program.
3. Once it is in the 319 Program, then include "activities to reduce atmospheric deposition" in the IUP.
4. Once in the IUP, apply for a guaranty.⁷

All this said, where does the matter stand today? How many states have the reduction of atmospheric deposition mentioned in their IUPs? How many states include atmospheric deposition in their 319 Programs?

A sample glance at the 319 Programs of the 10 states with the largest populations yields some interesting results. Illinois, New York, North Carolina, and Pennsylvania mention atmospheric deposition either on page one or otherwise prominently in their 319 Program descriptions. California, Florida, Georgia, Ohio, and Texas do not mention it at all. Michigan has a very surprising provision. Sec. 3.3.10 (p. 39), Paragraph 5, of "Michigan's Nonpoint Source Program Plan" says: "While atmospheric deposition is a significant NPS contributor to water quality impairments in Michigan, the NPS Program will continue to rely on regulatory programs at the state and federal level to reduce or eliminate sources of pollutants that impair water quality." So, apparently, the folks in Michigan do not plan on using their SRF as an incentive to reduce atmospheric deposition.

What about the IUPs in the four states that mention atmospheric deposition in their 319 Programs? New York, of course, has included it in its IUP. North Carolina and Pennsylvania⁸ have not. Illinois mentions it, but in a back-handed manner. Paragraph 7 of Section F (Long Term Goals (5-Year Timeframe) of the Illinois IUP lists as a goal: "To explore the expansion of eligibility to address issues of water efficiency, energy efficiency. . . ."

The answer is that recognition of atmospheric deposition as an eligible activity for funding under the 51 individual SRFs is not uniform, by any means, across the country. Maryland, home to the largest estuary in the United States, understandably mentions atmospheric deposition in both its 319 Program and its IUP, although they have no current plans for funding any energy-efficiency projects under this authority.

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7. It should be noted that, whereas the Act limits direct loans to terms of 20 years, there is no such limitation on the guaranty authority. Thus, for such projects as installing insulation—that lasts the life of the home itself—terms of 30 years can be used for the funding. This will have the effect of significantly reducing costs and, therefore, making the energy-efficiency program much more attractive.
 8. As of this writing, PennVest, the manager of the SRF in the Commonwealth, plans to launch a guaranty program in the Spring of 2014. But they have no current plans to include atmospheric deposition projects under this new program.

So, in short, if you are interested in undertaking such a program, you must first investigate the status of atmospheric deposition in the appropriate state documents. Begin, of course, with the IUP. If it is in the IUP, go ahead and contact the SRF staff.

If it is not in the IUP, check out the 319 Program. If atmospheric deposition is listed in the 319 Program but not in the IUP, then contact the SRF staff about getting it included in the IUP.

If it is not included in the 319 Program, the next place to go is the National Atmospheric Deposition Program (NADP), an EPA-sponsored program housed at the University of Illinois. The NADP website is loaded with information about deposition conditions in every state. Their staff is also very helpful by phone if you lose your way on the website.

Finally, it needs to be noted that the NYSERDA program need not be precisely replicated in other states, nor does the EFC's guaranty structure need to be replicated. All of the SRFs are AAA/Aaa rated. As long as their guaranty is for full and timely payment, that is all that should matter. The same applies to the NYSERDA program. There are many ways that an energy-efficiency loan program can be structured. Bringing a financial advisor on board early on is a good idea to help structure a successful program.

In August 2013, New York made history by using the financial authority and might of their SRF to guaranty a bond for energy-efficiency projects. It would be wise for other states to soon follow suit, either in the same manner or by employing an alternative structure. If so, the Clean Water State Revolving Fund could well be the next major player in the climate change/renewable energy game.